Mexico Economic Outlook

4Q20

Creating Opportunities

Research

01

Global Economic Outlook 4Q20

Creating Opportunities

Economic activity recovered rapidly in the third quarter, and is slowing in the fourth quarter due to the difficulty of controlling the pandemic

RECENT DEVELOPMENTS IN THE WORLD ECONOMY

Growth: 3Q20

Faster recovery than expected

Economic stimuli

Growing and significant

Growth: 4Q20

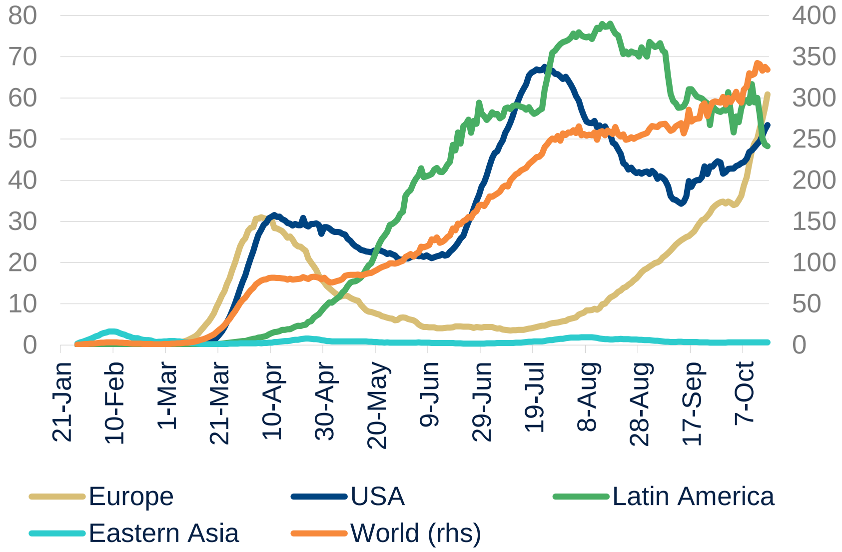
Signs of moderation

Evolution of the pandemic

Infections on the rise in Europe and high in the Americas

The pandemic is re-emerging in Europe, continues to worsen in the Americas and is under control in Eastern Asia

DAILY CASES OF COVID-19 (*)
(THOUSANDS OF PEOPLE, MOVING AVERAGE OVER THE LAST 7 DAYS)

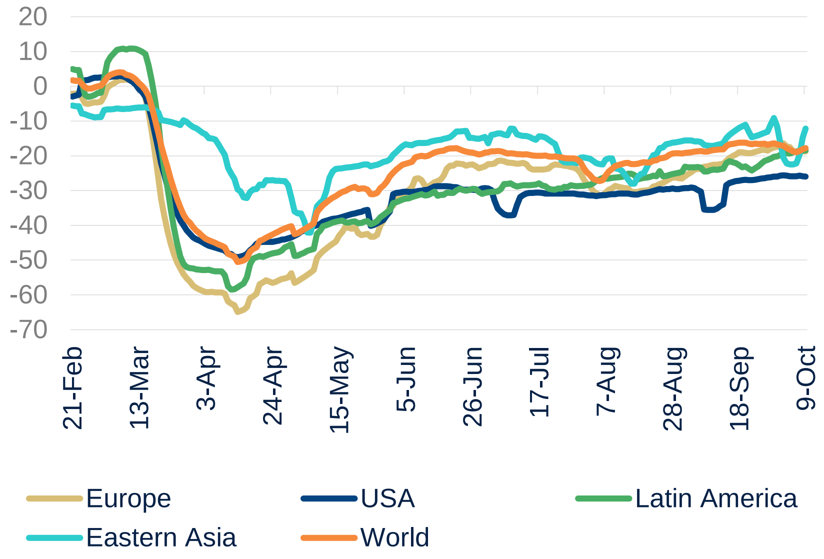


(*) Europe: Germany, Spain, France, Italy, Portugal, the United Kingdom and Turkey. Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay. Eastern Asia: China, South Korea, Japan and Singapore.
Source: BBVA Research based on data from Johns Hopkins University.

- Cases of COVID-19 worldwide have rebounded since September.
- Europe: infections on the rise, but with a relatively limited lethality so far.
- United States: after a respite, infections are back up in September.
- LATAM: infections are stable or falling, except in Argentina, where they are on the rise.
- China and other Asian countries: relatively under control.
- At least 10 vaccines are in the final phase of clinical evaluation, raising expectations that the virus will be controlled.

New confinement measures are less restrictive and more targeted than before

WORKPLACE MOBILITY INDICATOR (*)
(HIGHER VALUES INDICATE HIGHER MOBILITY)

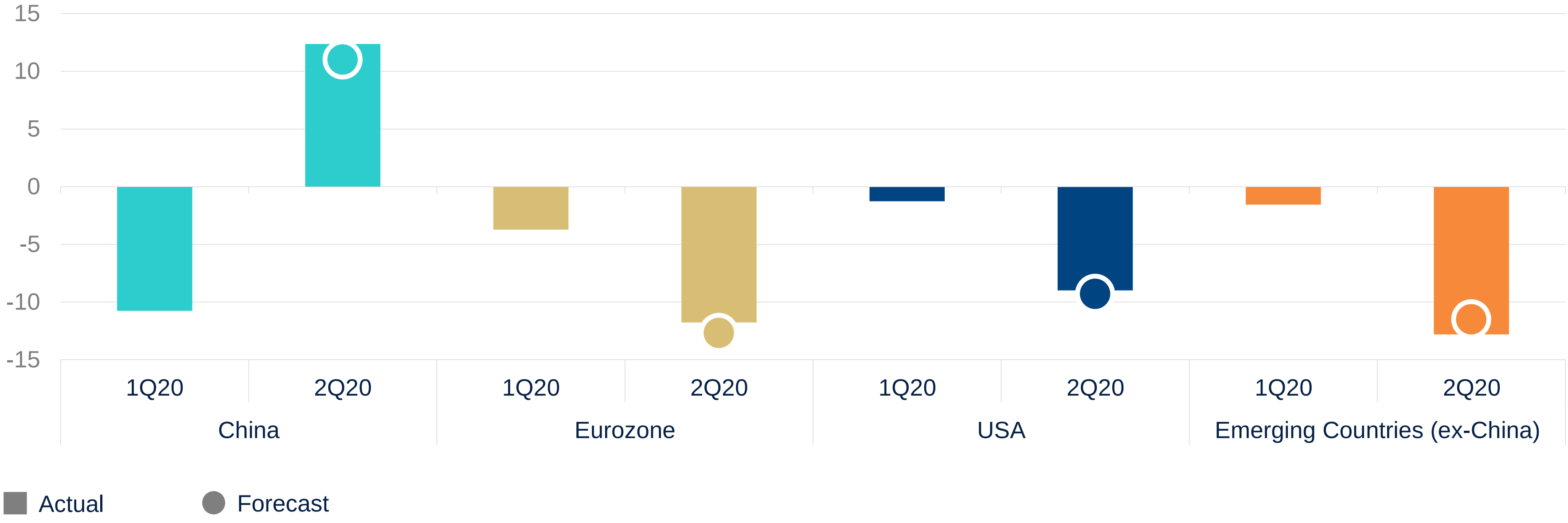


(*) Seven-days moving average. Reference period: January 3 to February 6. Europe: Germany, Spain, France, Italy, Portugal, United Kingdom and Turkey. Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Uruguay. Eastern Asia: China, South Korea, Japan and Singapore.
Source: BBVA Research based on the Google Mobility Reports.

- Mobility is greater now than in the first months of the pandemic:
  - preference for selective and less restrictive lockdowns
  - severe lockdowns have large economic and social costs
- But mobility remains below “normal” levels:
  - official restrictions in many countries (increasing in Europe)
  - changing habits as a result of inertia or fear of contagion
- Mobility will hardly go back to normal levels without a vaccine.

GDP has plummeted in the first half of the year, broadly in line with expectations

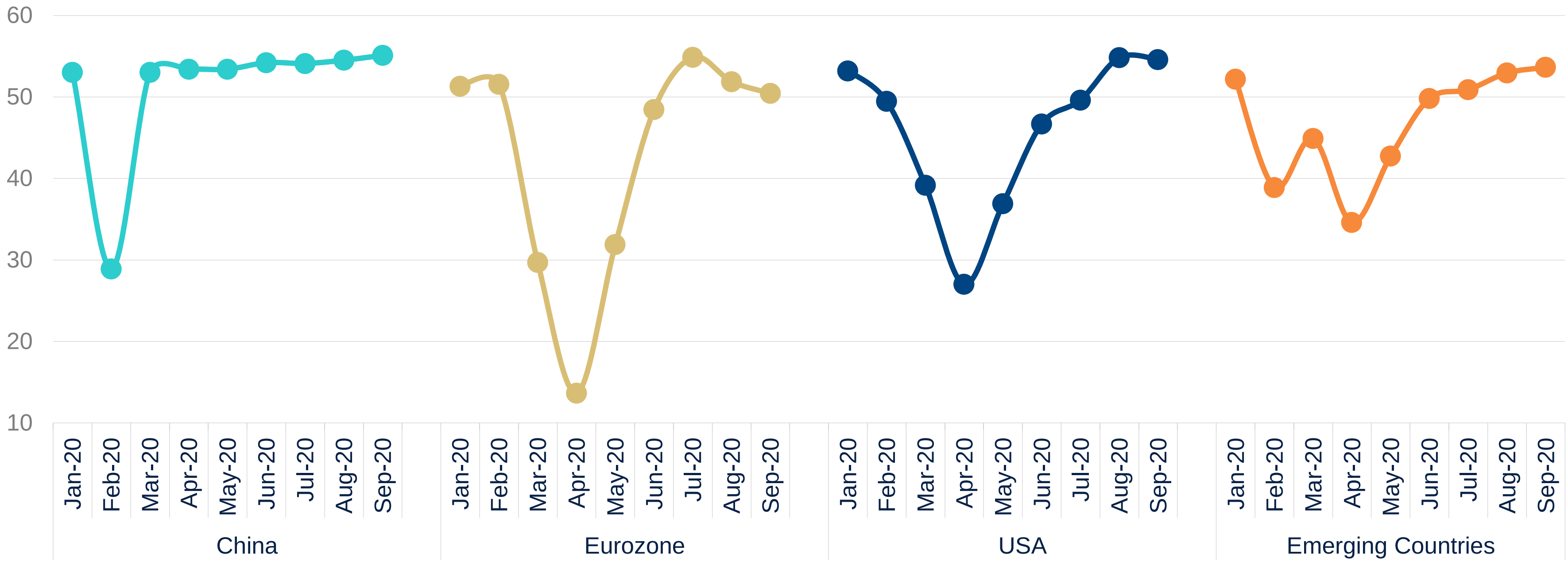
GDP GROWTH (*)
(QoQ %)



Emerging Countries: average of Argentina, Brazil, India, Indonesia, Mexico, Russia and Turkey.
Source: BBVA Research based on Haver data.

Faster-than-expected recovery since April, with increasing signs of moderation in the last few months

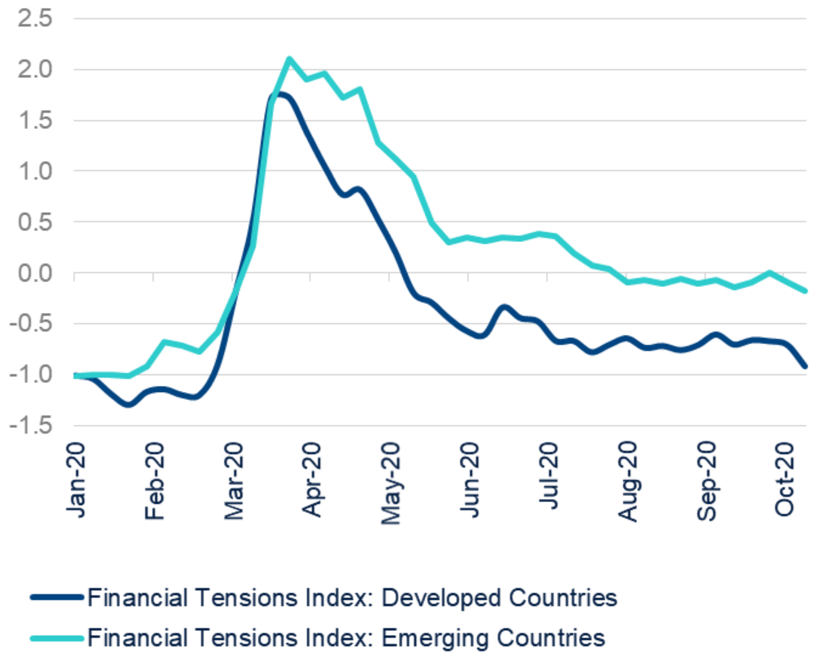
PMI INDICATORS
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)



Source: BBVA Research based on Haver data.

Financial tensions remain broadly stable, but they have not disappeared, particularly in emerging countries

FINANCIAL TENSIONS
(FINANCIAL TENSIONS INDEX: AVERAGE FROM 2006 = 0)

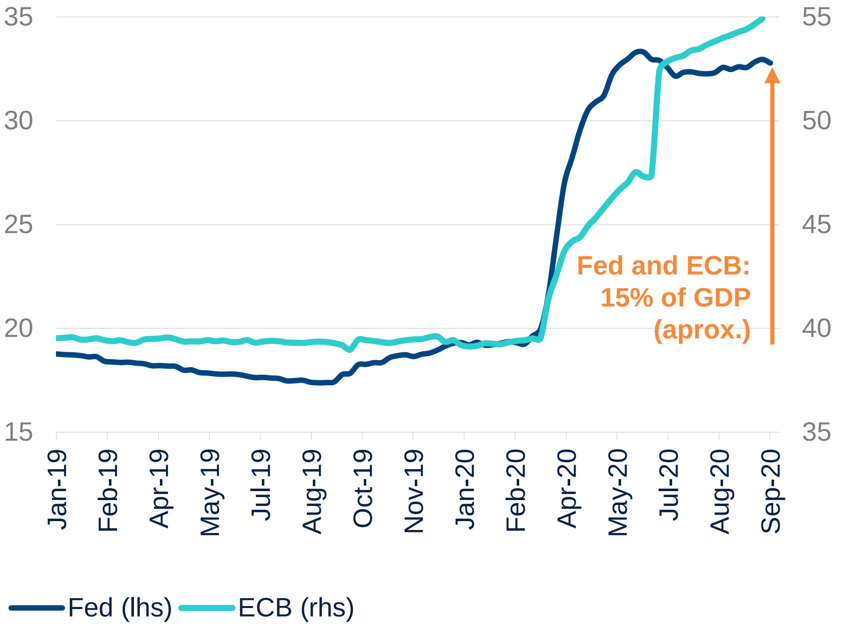


Source: BBVA Research

- Relative stability in financial markets in recent months.
- Economic stimulus and activity recovery are being supportive.
- The epidemiological context and geopolitical tensions still fuel risk aversion.
- Growing differentiation between markets and countries.

Central banks reinforce their commitment to maintain and, if needed, to increase the monetary stimulus

CENTRAL BANKS BALANCE SHEET
(% OF GDP)



Source: :BBVA Research based on Fed and ECB data

- The Fed has revised its strategy:
  - more flexible inflation target (average of 2%)
  - focus on reaching full employment
  - willingness to keep interest rates low for a longer period and expand asset purchases
- The ECB exhibits concerns on low inflation (hence on the recent exchange rate appreciation)...
- ... it deems adequate to maintain the monetary stimulus in place and it is ready to further use all its tools.

The activity recovery will only consolidate once effective vaccines or treatments spread

FORECAST ASSUMPTIONS

COVID-19

Gradual improvement following the approval and the distribution of a vaccine in 1H21 in main economies, in 2H21 in the rest.

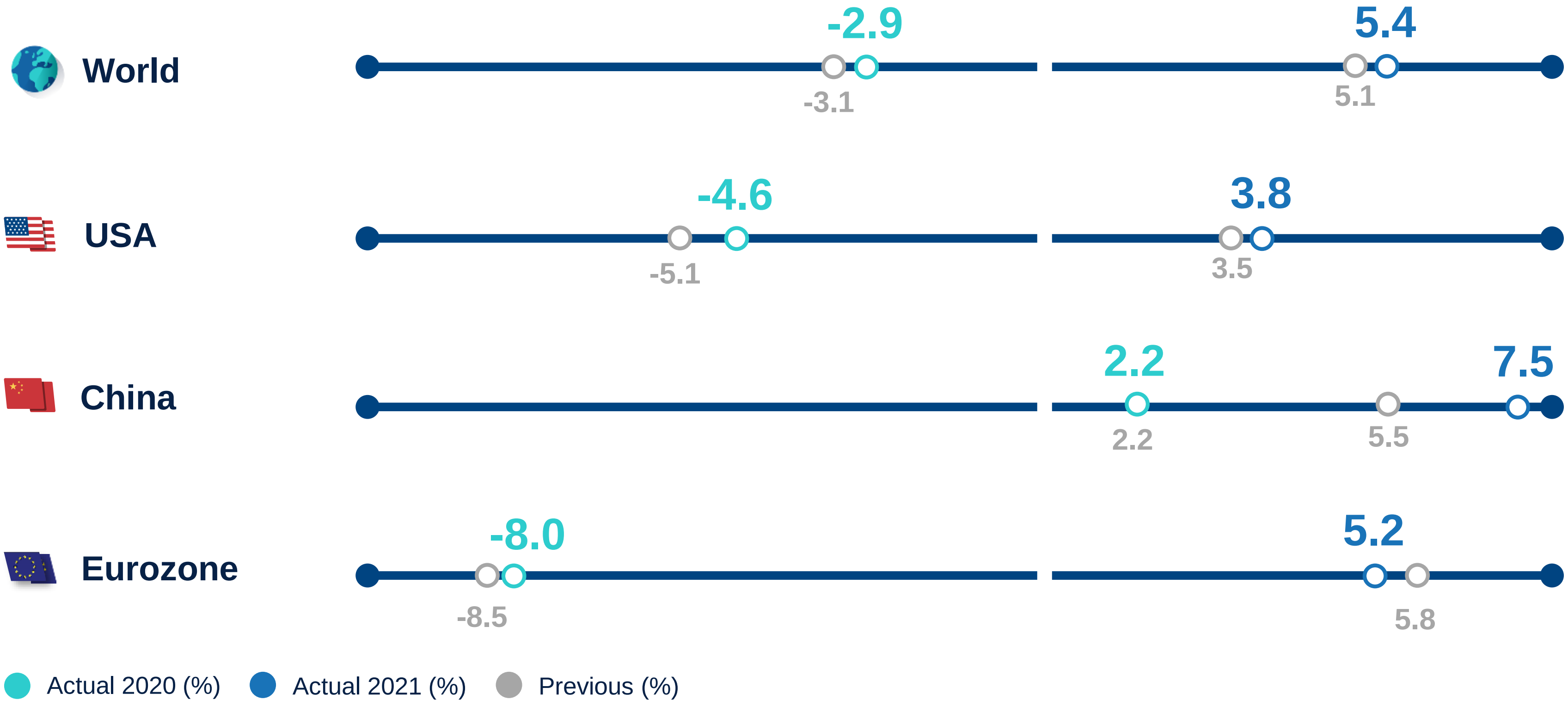
Economic Policy

Stimulus will be maintained, at least, until recovery consolidates.

Financial Markets

Gradual reduction of volatility and risk aversion throughout 2021.

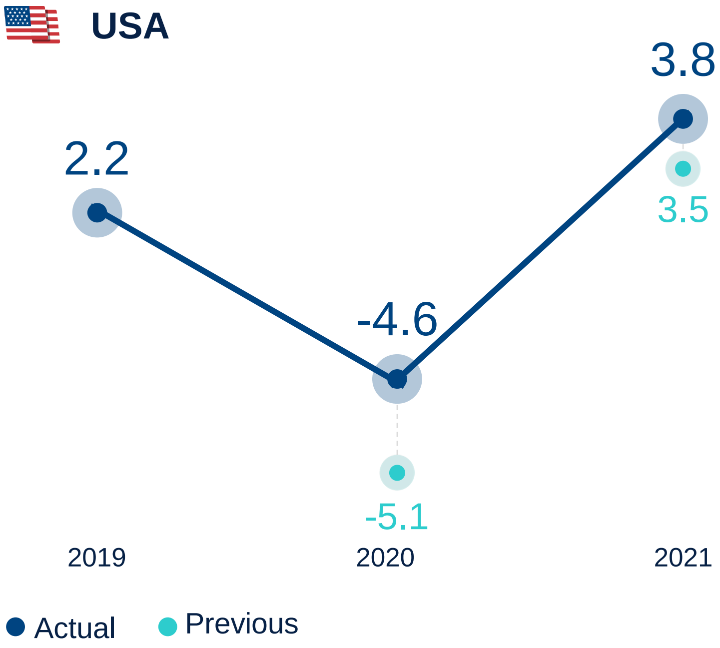
Upward adjustment in global growth forecasts



Source: BBVA Research.

US: a relatively faster recovery; lower-for-longer interest rates

GDP: ANNUAL GROWTH
(%)



Source: BBVA Research.

- GDP revised upwards on relatively positive incoming data, significant policy support and expected easing of social distancing norms.
- GDP will recover pre-crisis levels in 2022.
- Labor market: fast but partial recovery.
- Policy rates to remain unchanged till 2025, taking the Fed's revised strategy into account.
- Uncertainty on further fiscal stimulus, which will also depend on the elections results.
- Inflation forecasts adjusted upwards on less negative activity and Fed's tolerance with higher price pressures.
- Risks: Covid, elections, fiscal situation of regional governments.

More balanced risks

Upside risks

- Earlier-than-expected vaccine distribution and/or new treatments favoring:
  - sharper confidence recovery
  - lower global risk aversion.
- Additional fiscal and monetary stimulus.
- Improvement in global governance.

Downside risks

- Increase of infections and lower effectiveness of vaccines and treatments.
- Second-round effects of the pandemic:
  - corporate bankruptcies
  - public debt sustainability.
- Financial stress, capital outflows from EMs.
- Geopolitical, political and social tensions.
- De-globalization.

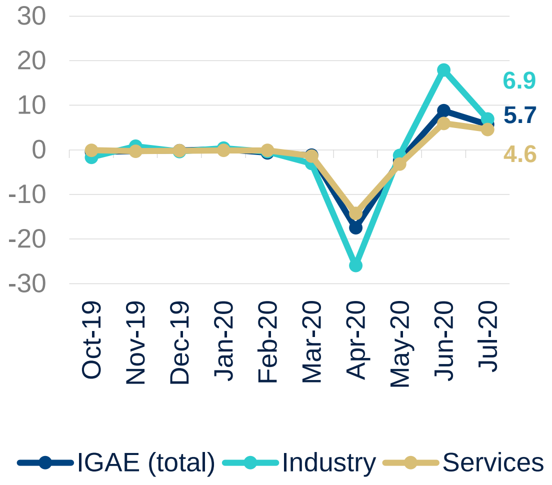
BBVA Research

02

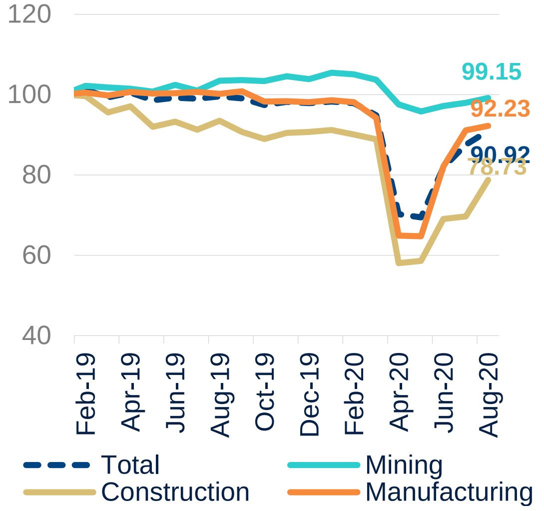
Significant risks remain on the long road toward economic recovery

Economic activity recovers in 3Q20 but will slow in a context of weak domestic demand

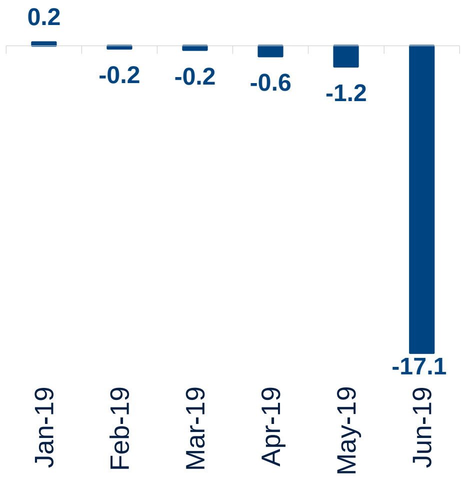
IGAE
(% M/M, SA)



INDUSTRIAL ACTIVITY
(2019/01 INDEX = 100, SA)



GDP
(% Q/Q, SA)

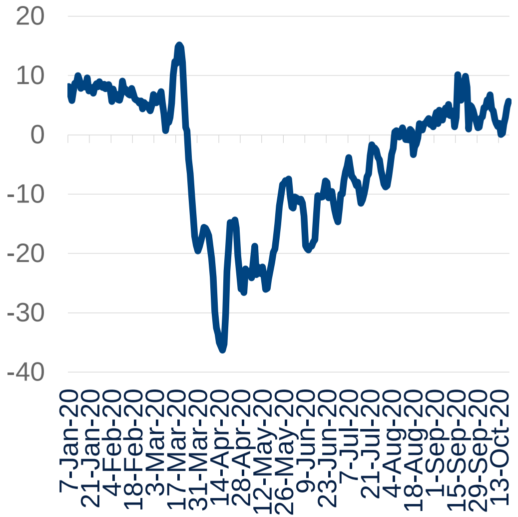


Source: BBVA Research/INEGI

The slow recovery in disposable household income, the prolonged pandemic and weak investment (due to temporary inconsistency problems as a result of unfortunate economic policy decisions) will all continue to hamper growth in the future.

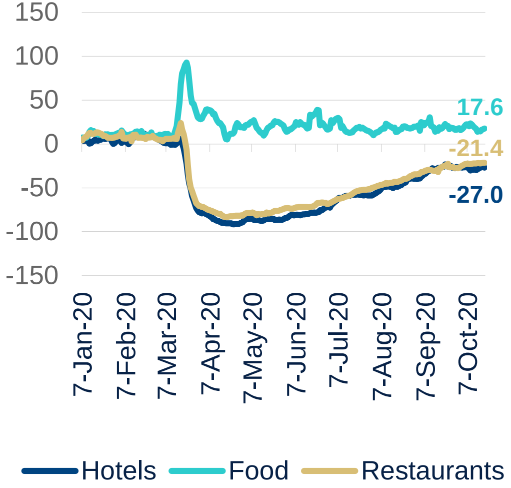
Consumption gained ground, however recovery will lose momentum as the initial boost resulting from increased mobility fades

BBVA CONSUMPTION INDICATOR*
(% Y/Y, REAL, 7-DAY MOVING AVERAGE)

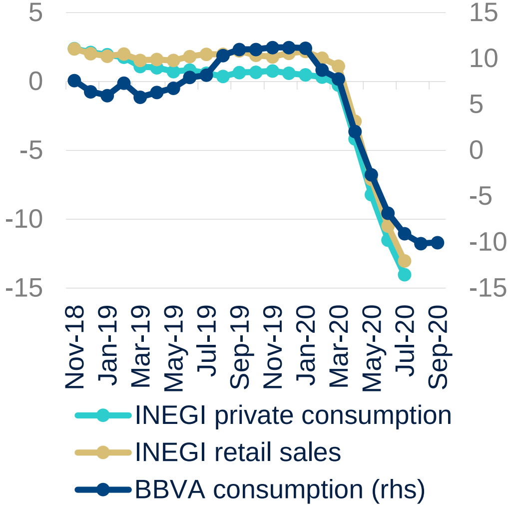


* Closing date: October 19, 2020.
Source: BBVA Research/INEGI

BBVA CONSUMPTION INDICATOR: HOTELS, FOOD AND RESTAURANTS
(% Y/Y, REAL, 7-DAY MOVING AVERAGE)



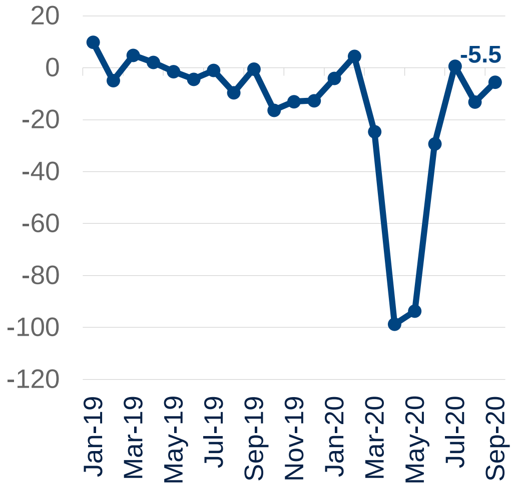
BBVA CONSUMPTION INDICATOR VS. INEGI CONSUMPTION INDICES
(% Y/Y, REAL, 6-MONTH MOVING AVERAGE)



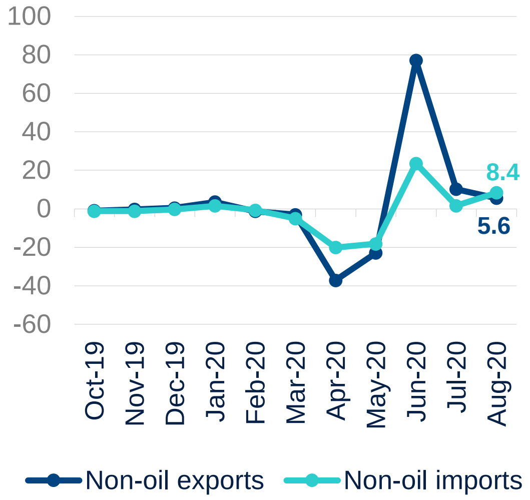
Some economic sectors, such as hotels and restaurants remain in negative territory.

Recovery of the manufacturing sector in the US continues to point toward an acceleration in external demand, albeit at a slower pace

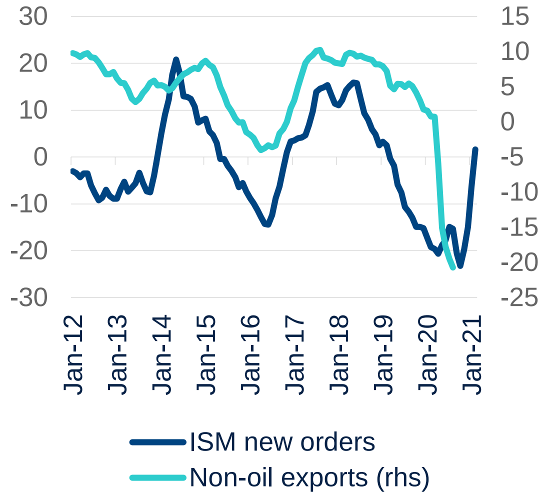
OUTPUT OF LIGHT VEHICLES
(% Y/Y, ORIGINAL)



NON-OIL IMPORTS AND EXPORTS
(% M/M, SA)



ISM NEW ORDERS INDEX AND NON-OILEXPORTS (% Y/Y, SA, 6-MONTH MOVING AVERAGE)

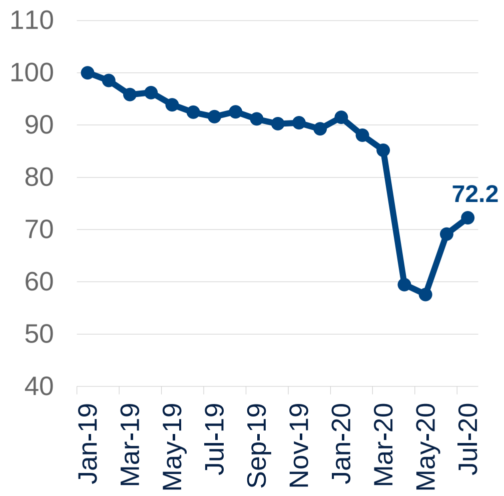


Source: BBVA Research/INEGI

The risk of stagnation persists due to a lack of control over the pandemic.

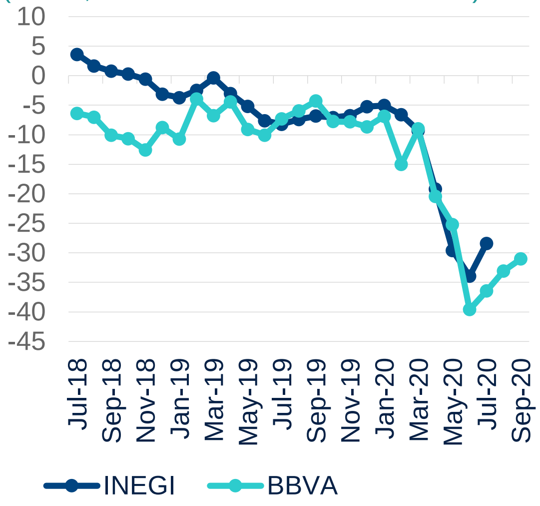
Investment remains 21% below its pre-COVID level and the BBVA investment indicator continues to register significant year-on-year declines: -28.4% in 3Q20

GROSS FIXED INVESTMENT (INEGI)
(2019/01 = 100, SA)



BBVA INVESTMENT INDICATOR*
(% Y/Y, 28-DAY MOVING AVERAGE)

BBVA INVESTMENT INDICATOR VS INEGI INVESTMENT INDEX
(% Y/Y, 3-MONTH MOVING AVERAGE)



* Closing date: October 16, 2020.
Source: BBVA Research/INEGI

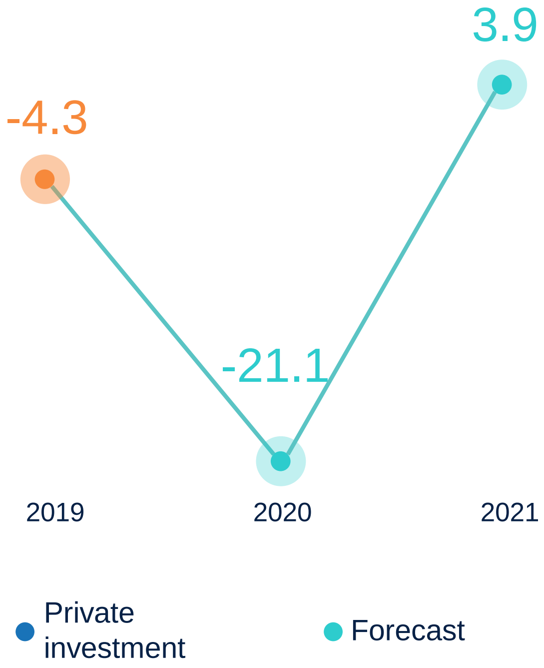
The adverse effects of COVID add to the uncertain environment created by federal government decisions with regard to economic policy.

We revised our growth forecast for 2020 upward to -9.3% (previously -10%). However, we maintain our growth forecast of 3.7% for 2021

GDP
(ANNUAL CHANGE %, SA)

PRIVATE CONSUMPTION
(ANNUAL CHANGE %, SA)

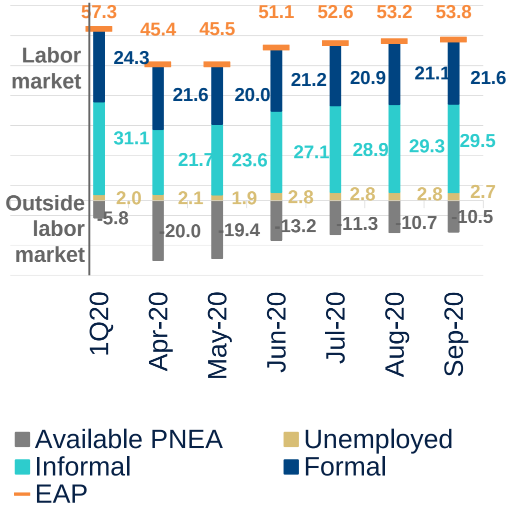
PRIVATE INVESTMENT
(ANNUAL CHANGE %, SA)



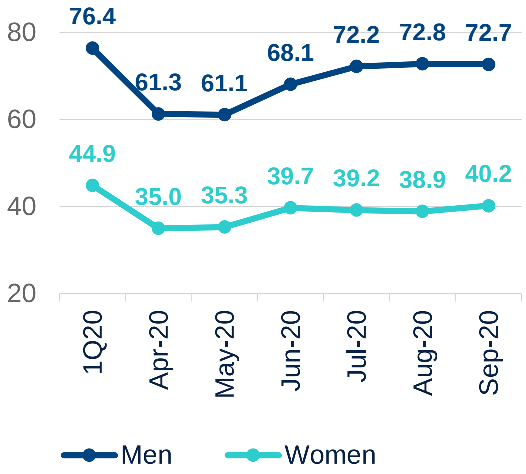
Source: BBVA Research/INEGI

Weak labor market recovery caused mainly by growth in informal labor

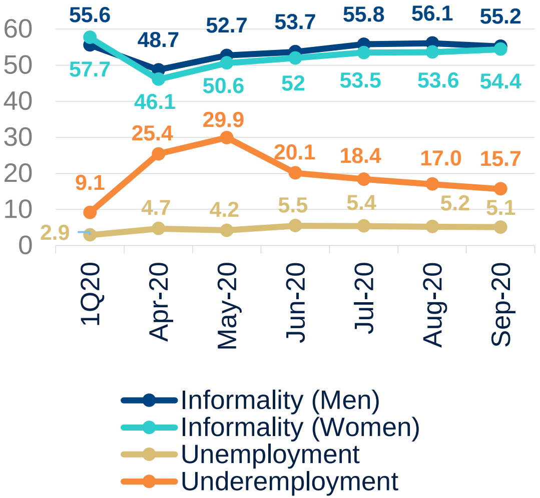
IMPACT OF COVID-19 ON EMPLOYMENT ACTIVITY (MILLIONS)



LABOR PARTICIPATION RATE (%)



LABOR MARKET RATES (%)

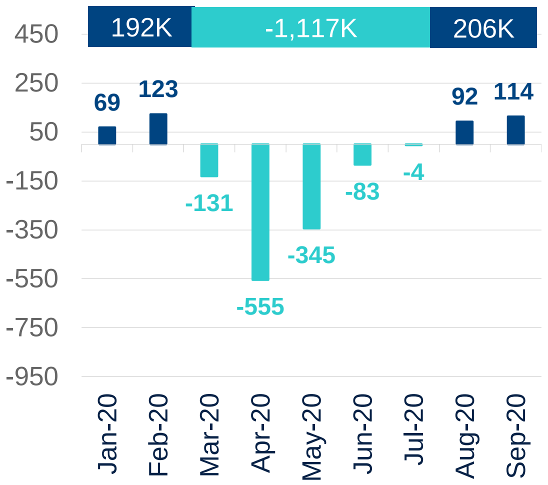


BBVA Research/INEGI (ENOE, ETOE AND ENOE-N).

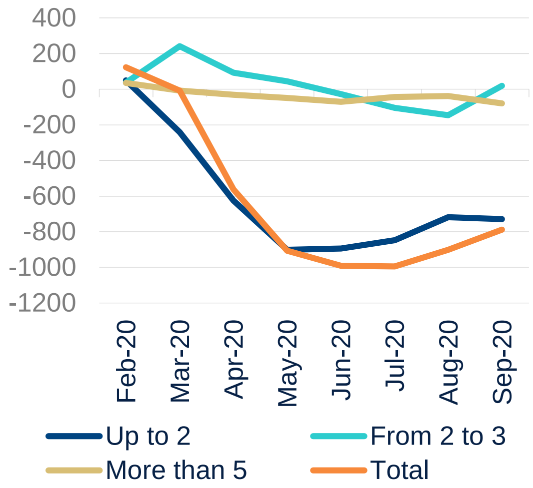
4.7 million people have been driven out of the labor market and have not yet been able to return to work, with women being the most affected. High levels of underemployment prevail, with a rate 5 pp higher than the pre-pandemic level.

Less than 20% of formal jobs lost have been recovered in August and September, while jobs paying +5X MW continue being lost

FORMAL EMPLOYMENT
(THOUSANDS, MONTHLY CHANGE)

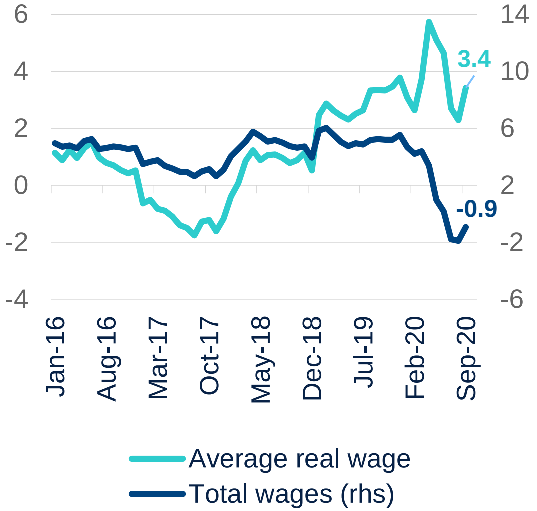


FORMAL EMPLOYMENT BY INCOME LEVEL (MW) (THOUSANDS, CUMULATIVE MONTHLY CHANGE.)



MW — Minimum wage.

REAL WAGES AND TOTAL WAGE BILL
(ANNUAL CHANGE %)

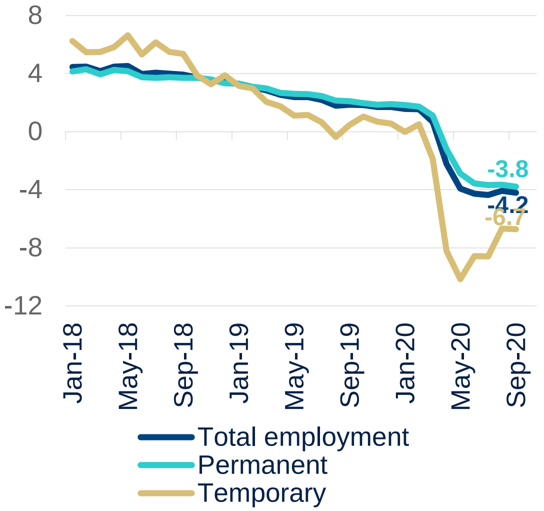


Source: BBVA Research/IMSS.

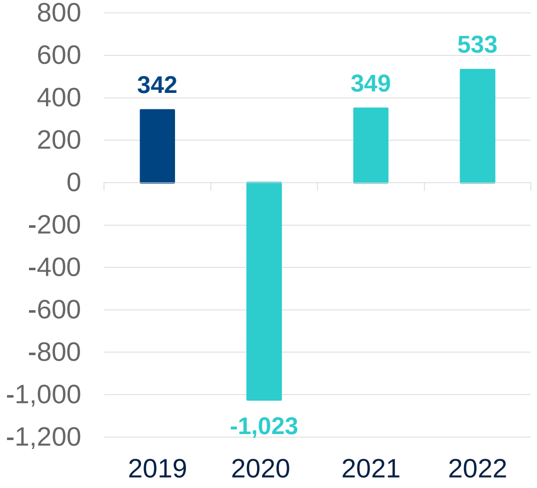
The largest employment deficit is for workers with incomes up to 2X MW. The slowdown in growth of jobs paying up to 2X MW and the creation of jobs paying 2–3X MW contributed to the increase in real wages.

The labor market will not recover until the end of 2023 or early 2024

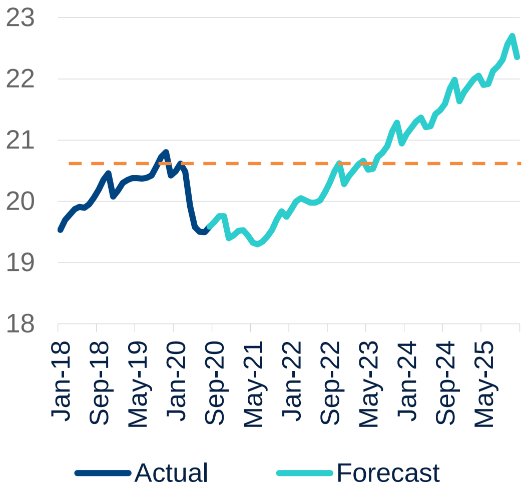
FORMAL EMPLOYMENT
(ANNUAL CHANGE %)



FORMAL EMPLOYMENT
(THOUSANDS, ANNUAL CHANGE TO DEC)



FORMAL EMPLOYMENT
(MILLIONS)

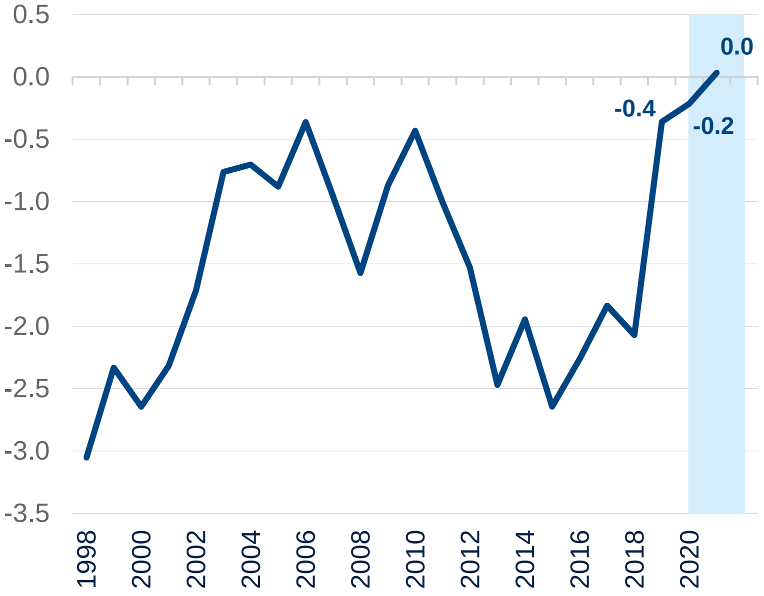


Source: BBVA Research/IMSS.

Tentative employment recovery with negative year-on-year rates. The recovery of temporary employment slowed and permanent employment remained at almost the same level as in July.

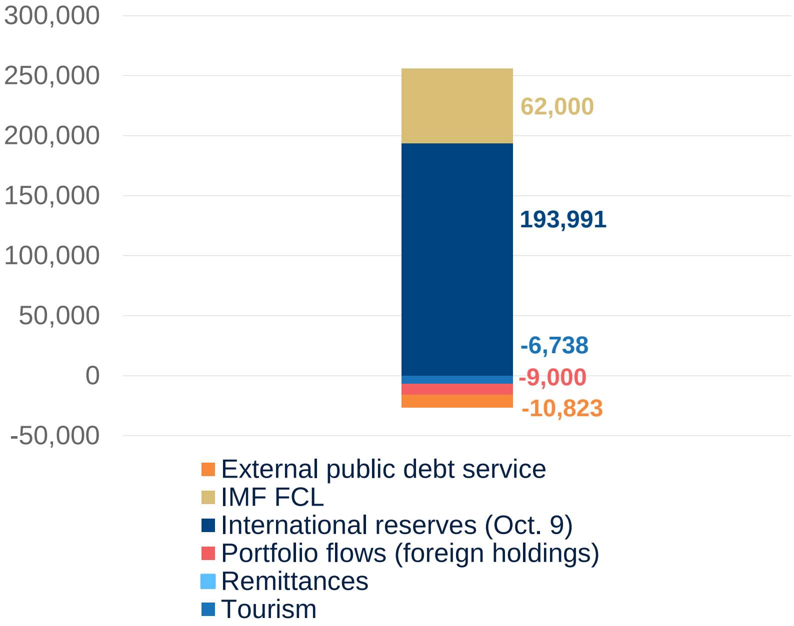
There are no significant risks to the balance of payments

CHECKING ACCOUNT
(% OF GDP)



Source: BBVA Research/Banxico.

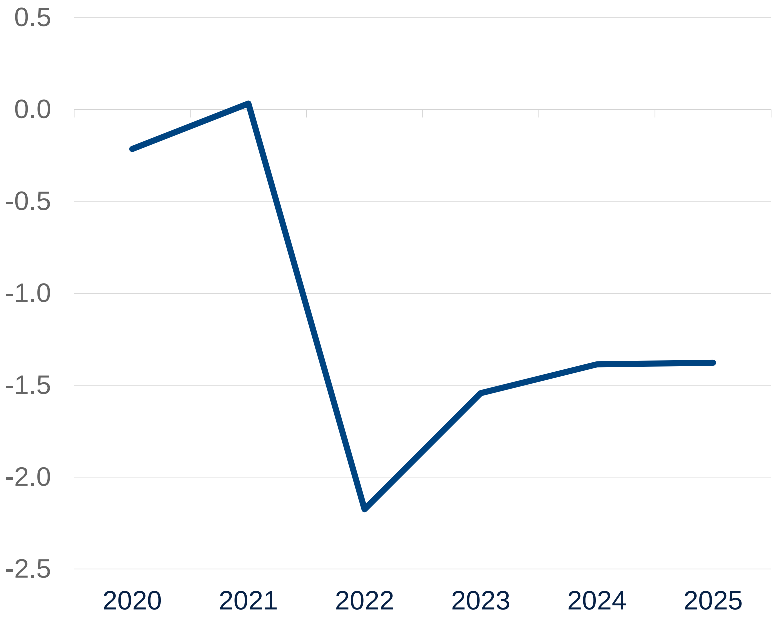
ESTIMATED FOREIGN OUTFLOWS AND INTERNATIONAL BUFFERS IN 2020
(USD MILLION)



Source: BBVA Research/Banxico and IMF.

In the medium term, the checking account deficit will stabilize at around 1.5% of GDP

CHECKING ACCOUNT FORECASTS 2020–2025
(% OF GDP)



Source: BBVA Research/Banxico.

We do not think there is a structural problem with checking account financing:

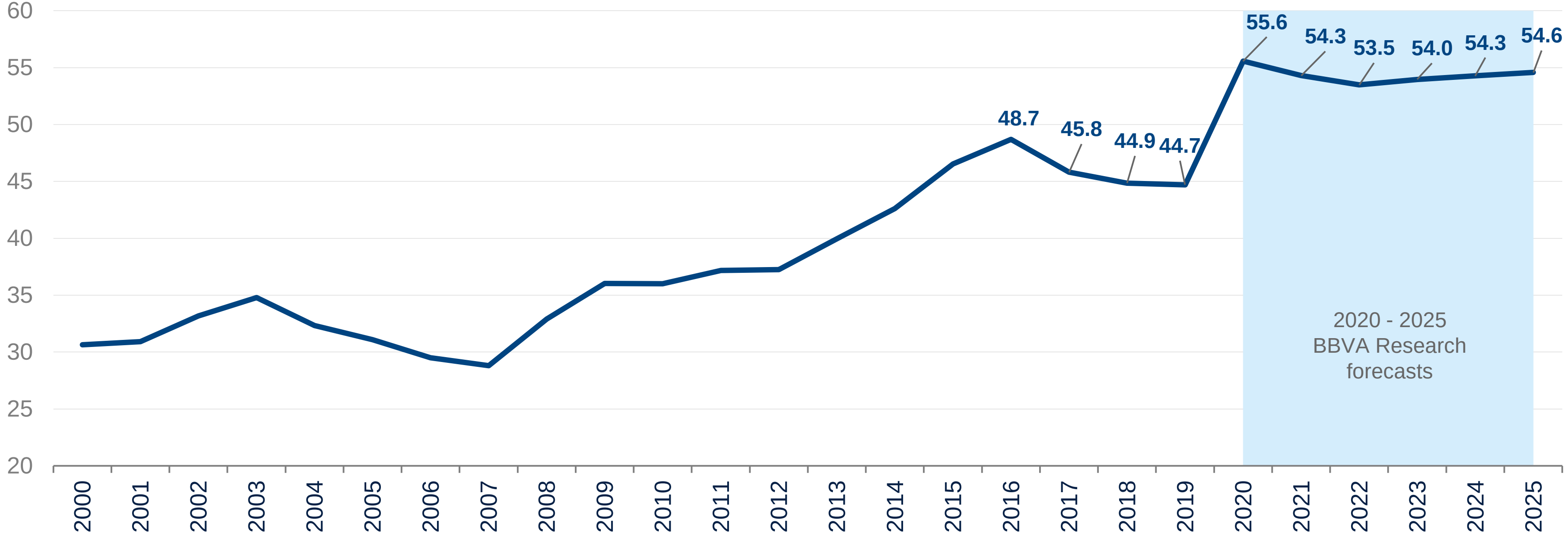
- Increased foreign direct investment (FDI) and portfolio flows will accompany economic recovery in coming years.
- The United States–Mexico–Canada Agreement (USMCA), near-shoring and the recovery of global manufacturing will help increase FDI flows to Mexico in the coming years.
- International remittances will continue to be a significant source of funding the checking account deficit.

The 2021 economic package is based on relatively optimistic GDP and income assumptions

- The economic package reinforces signs of fiscal discipline by seeking a primary balance of 0% of GDP. It is positive that the federal government has proposed this goal instead of the deficit of 0.6% of GDP that it had suggested in the 2021 Pre-Criteria document.
- However, the assumptions of the economic package are relatively optimistic in two ways: (i) an economic growth of 1.2 pp above the analysts' consensus and (ii) an average oil output of 1.86 million barrels per day.
- The government projects that public sector borrowing requirements (PSBR) will be 3.4% of GDP and the historical balance of PSBR will be 53.7% of GDP in the coming year.
- It is therefore advisable that, once the economic growth figures for the first quarter of 2021 are available, any adjustments necessary to meet fiscal targets are made.
- As a result of the increased optimism for economic growth in 2021, there is a clear downward bias of the balance of risks for tax revenues.
- The federal government should design and implement a comprehensive tax reform that comes into force once the pandemic crisis is over. Otherwise the loss of investment-grade status would be very likely.

Public debt (% of GDP) will remain stable in 2021 provided that a tax reform is implemented

HISTORICAL BALANCE OF PUBLIC SECTOR BORROWING REQUIREMENTS
(% OF GDP)



Source: BBVA Research/SHCP.

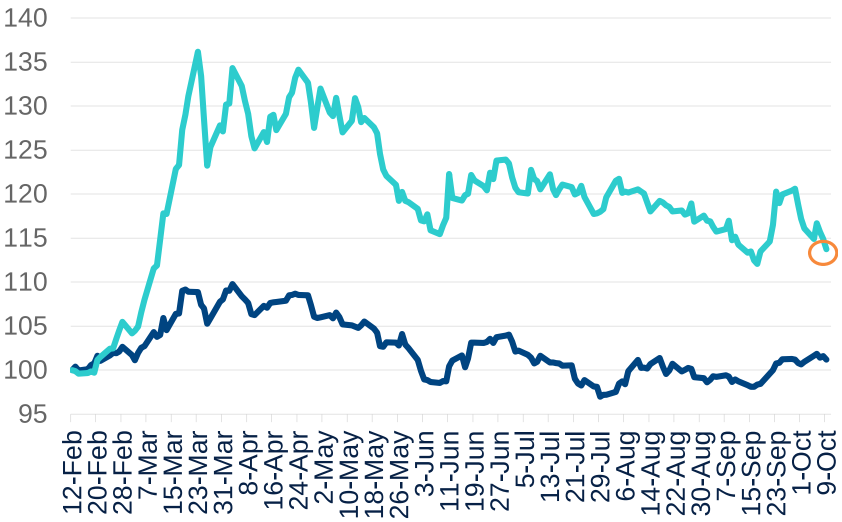
Research

03

There is still leeway for the peso to appreciate further

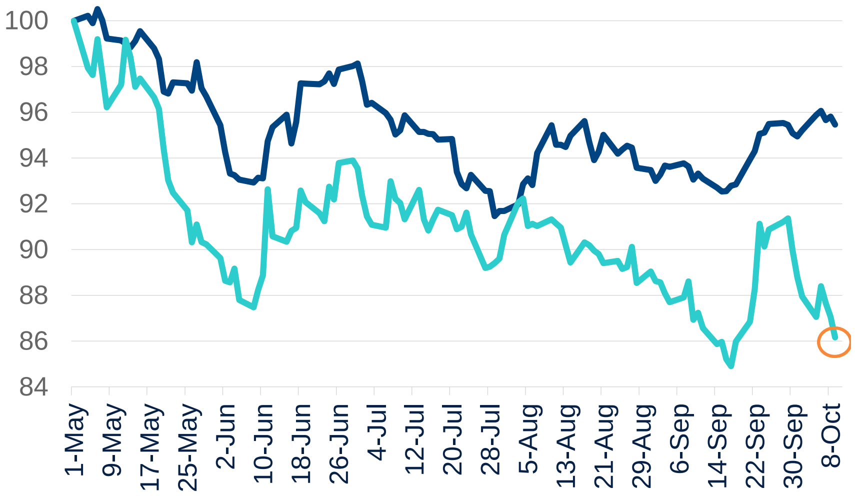
The peso has performed positively since May, partially recovering from the marked negative performance between February and April

RELATIVE PERFORMANCE OF MXN AGAINST OTHER EM CURRENCIES* (FOLLOWING THE REBOUND IN GLOBAL RISK AVERSION, INDEX, FEBRUARY 12, 2020 = 100)



EM currencies MXN -13.7% Depreciation
-12.5% Low yield

RELATIVE PERFORMANCE OF MXN AGAINST OTHER EM CURRENCIES* (SINCE EARLY MAY, INDEX, MAY 1, 2020 = 100)



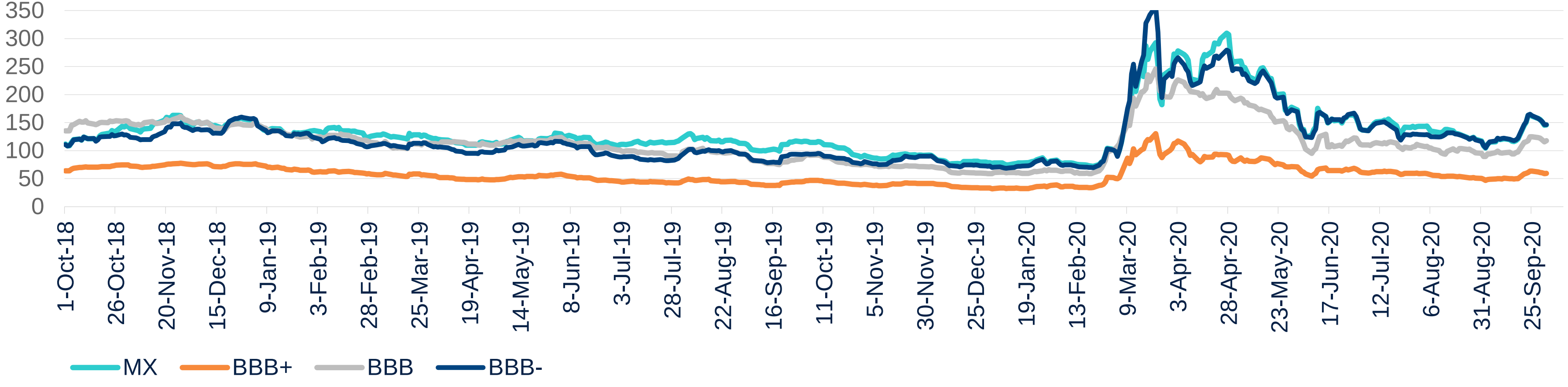
EM currencies MXN +13.8% Appreciation
+9.3% High yield

* Weighted liquidity average and compared to trade based on a new weighting by JP Morgan after removing the Mexican peso; own calculations.
Source: BBVA Research/Bloomberg

The recovery of the peso has been accompanied by a lower risk premium and a greater global risk appetite.

It is unlikely that a real depreciation of approximately 25% to 30% will be permanent. Therefore, the Mexican peso will appreciate when global risk aversion toward emerging markets (EMs) decreases.

5Y CDS
(bp)

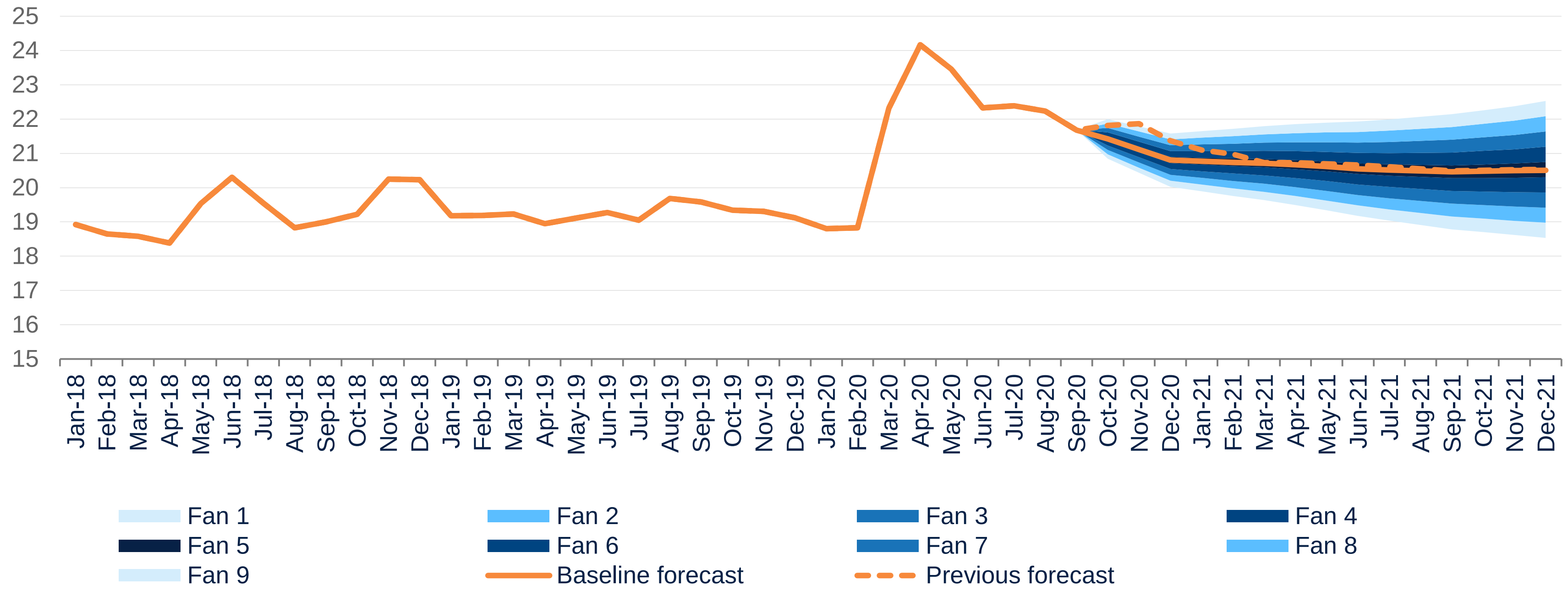


Source: BBVA Research/Bloomberg.

The peso has also benefited from an improvement in the checking account and more recently, from the austere budget planned for 2021.

There is still leeway for the peso to appreciate in the near future

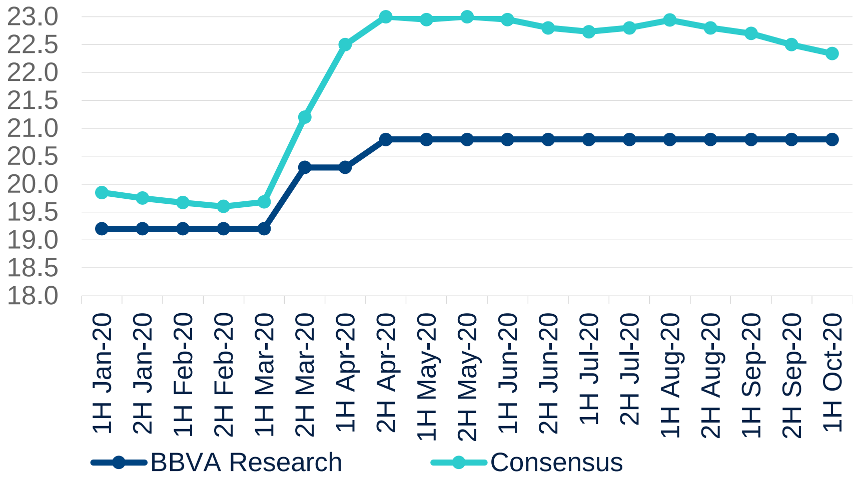
EXCHANGE RATE
(MXN/USD)



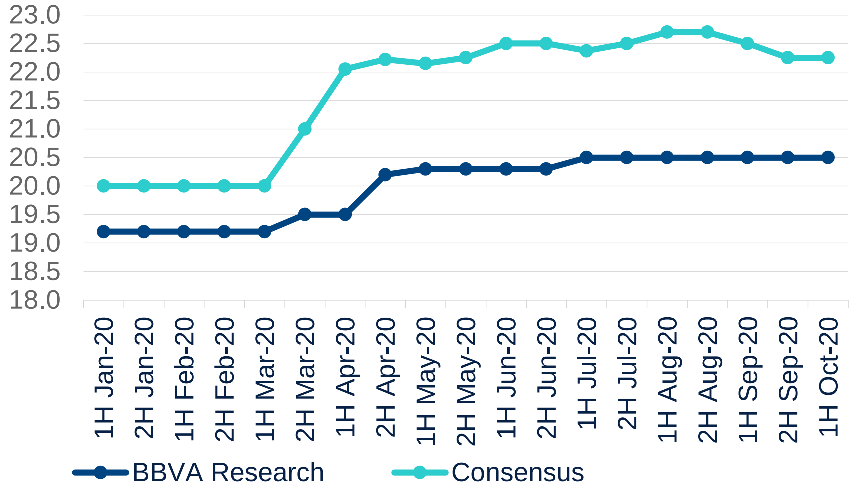
Source: BBVA Research/Bloomberg.

Following significant growth, our forecast of increased appreciation was right, something that the consensus did not predict

ANALYSTS' EXPECTATIONS FOR THE EXCHANGE RATE IN 2020 (EOP, PPD, BBVA RESEARCH VS. CONSENSUS)



ANALYSTS' EXPECTATIONS FOR THE EXCHANGE RATE IN 2021 (EOP, PPD, BBVA RESEARCH VS. CONSENSUS)

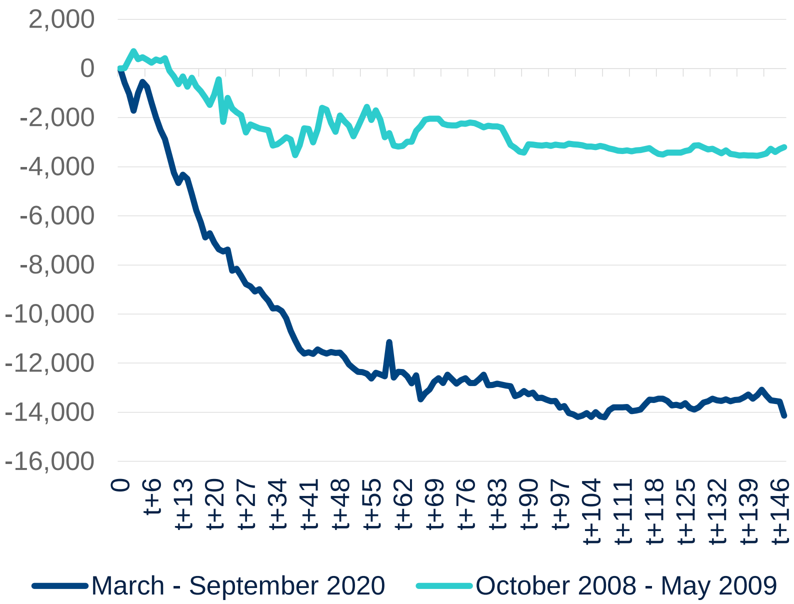


Source: BBVA Research/CitiBanamex bi-weekly surveys.

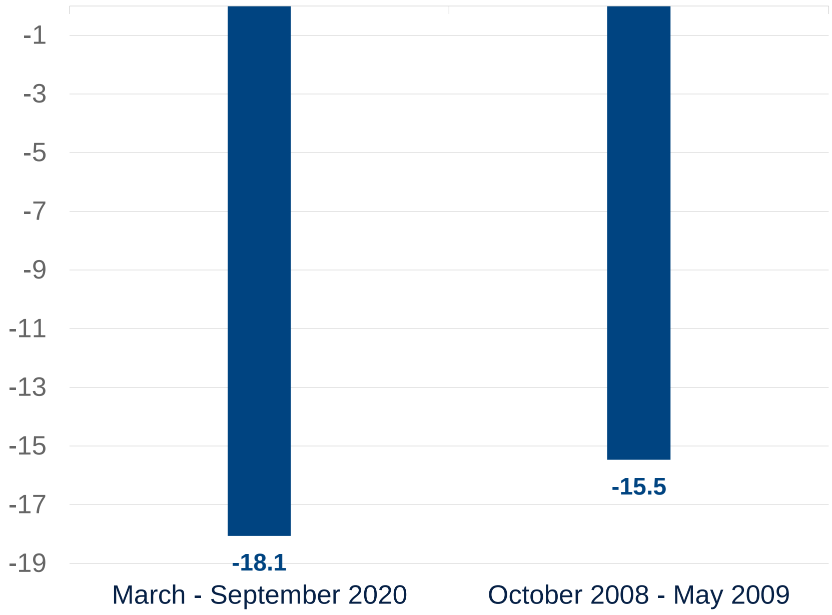
Gradually, analysts have endorsed the prospect of a stronger peso. However, our forecast, which predicted some leeway for further currency appreciation, continues to collide with consensus expectations of a weak MXN in the future.

Uncertainty regarding the new US fiscal stimulus resulted in a net outflow of foreign funds at the end of September

CUMULATIVE CHANGE IN FOREIGN M-BOND HOLDINGS
(USD MILLIONS, NOMINAL VALUE)



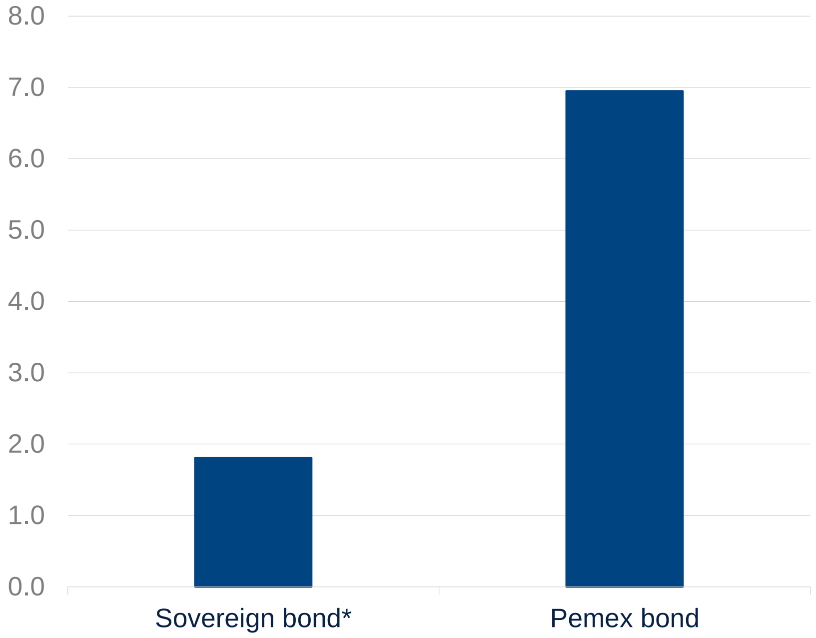
CHANGE IN FOREIGN M-BOND HOLDINGS (% MXN, NOMINAL VALUE)



Source: BBVA Research/Banxico.

Pemex returned to the international debt market in October

5-YEAR YIELD
(DOLLAR BONDS, %)



* Corresponds to the generic 5-year bond calculated by Bloomberg
Source: BBVA Research/Bloomberg

- The amount issued was USD 1.5 billion.
- The term of the issuance was five years.
- The yield stood at 6.95% at a fixed rate in in USD, a significant spread compared to the sovereign risk during the same period.

BBVA Research

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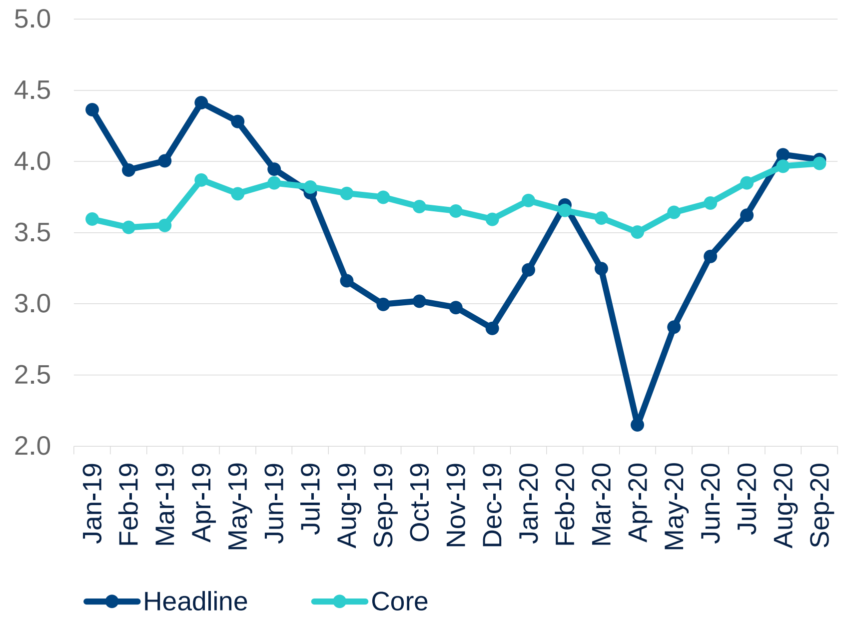
We continue to anticipate a slowdown in inflation and lower interest rates, however we now expect these lower levels to be delayed for a few months

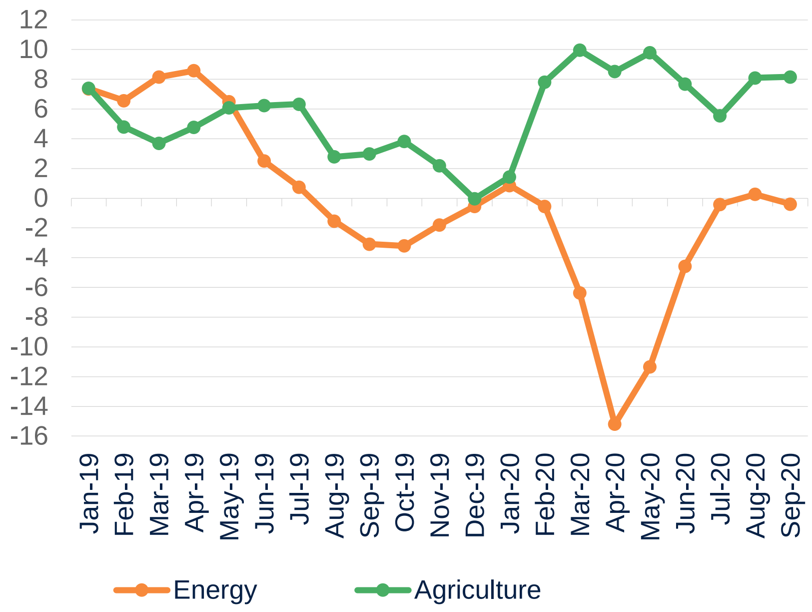
The rebound in headline and core inflation is mainly due to temporary factors

HEADLINE AND CORE INFLATION
(Y/Y CHANGE %)



Source: BBVA Research/INEGI.

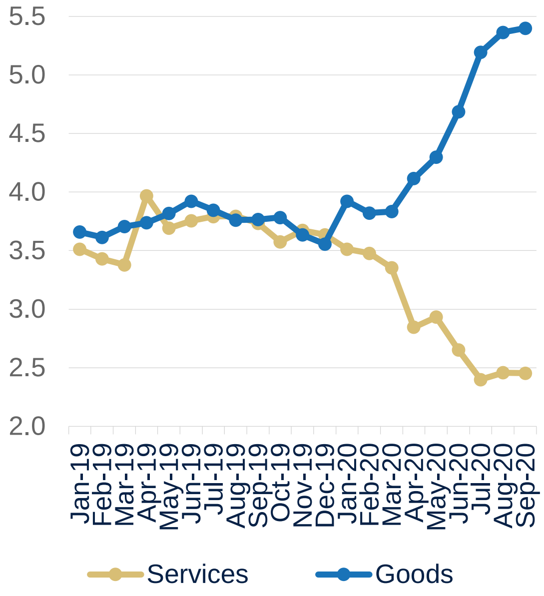
NON-CORE INFLATION: FRESH FOOD AND ENERGY
(Y/Y CHANGE %)



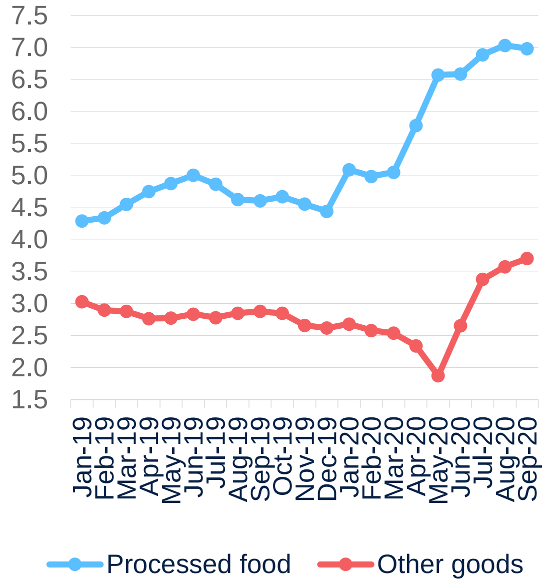
Source: BBVA Research/Banxico.

Lower inflation in services has not been enough to offset the upward trend of goods

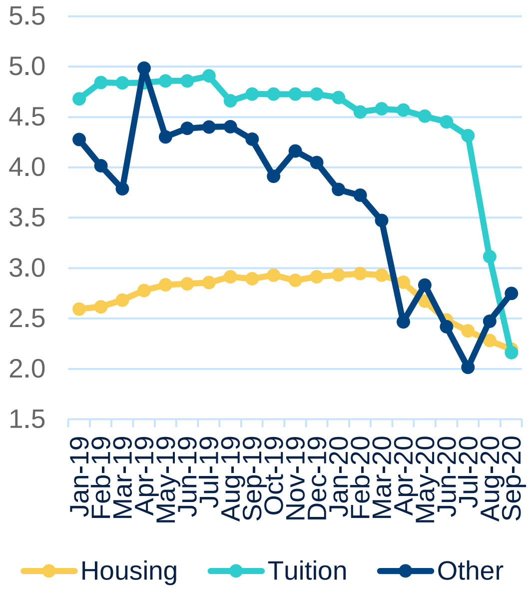
CORE INFLATION: GOODS VS. SERVICES
(Y/Y CHANGE %)



GOODS: PROCESSED FOODS AND OTHERS
(Y/Y CHANGE %)



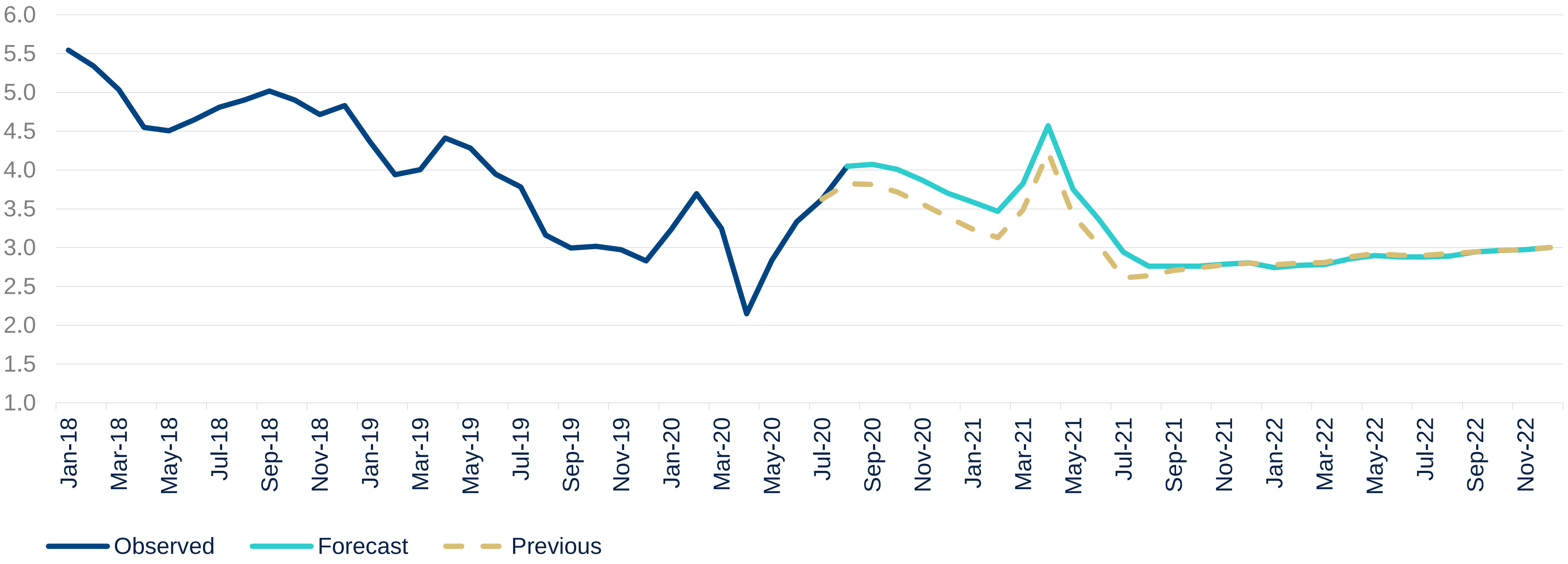
SERVICES: HOUSING, EDUCATION AND OTHERS
(Y/Y CHANGE %)



Source: BBVA Research/INEGI.

The downward trend in headline inflation will be slower than previously expected

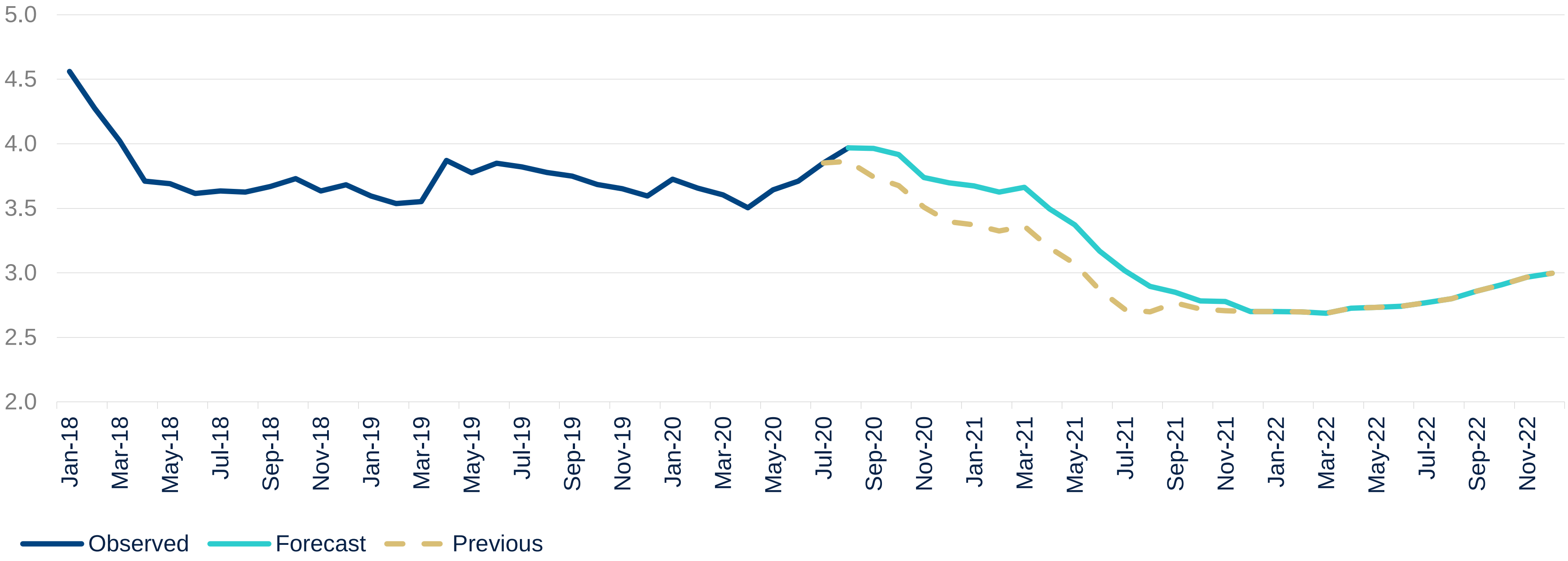
HEADLINE INFLATION FORECASTS
(Y/Y CHANGE %)



Source: BBVA Research/INEGI.

After the peak in August/September, core inflation will gradually slow…

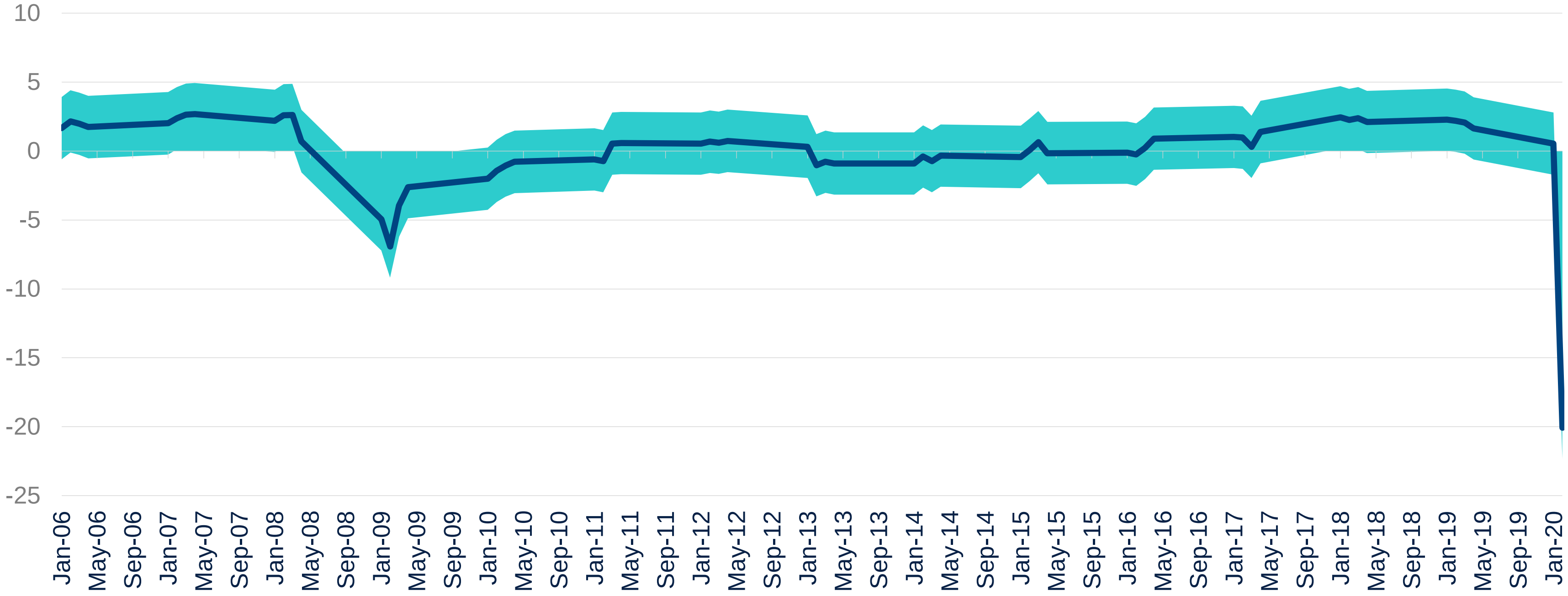
FORECASTS FOR CORE INFLATION
(Y/Y CHANGE %)



Source: BBVA Research/INEGI.

…as a result demand continuing to be weak

OUTPUT GAP
(%)

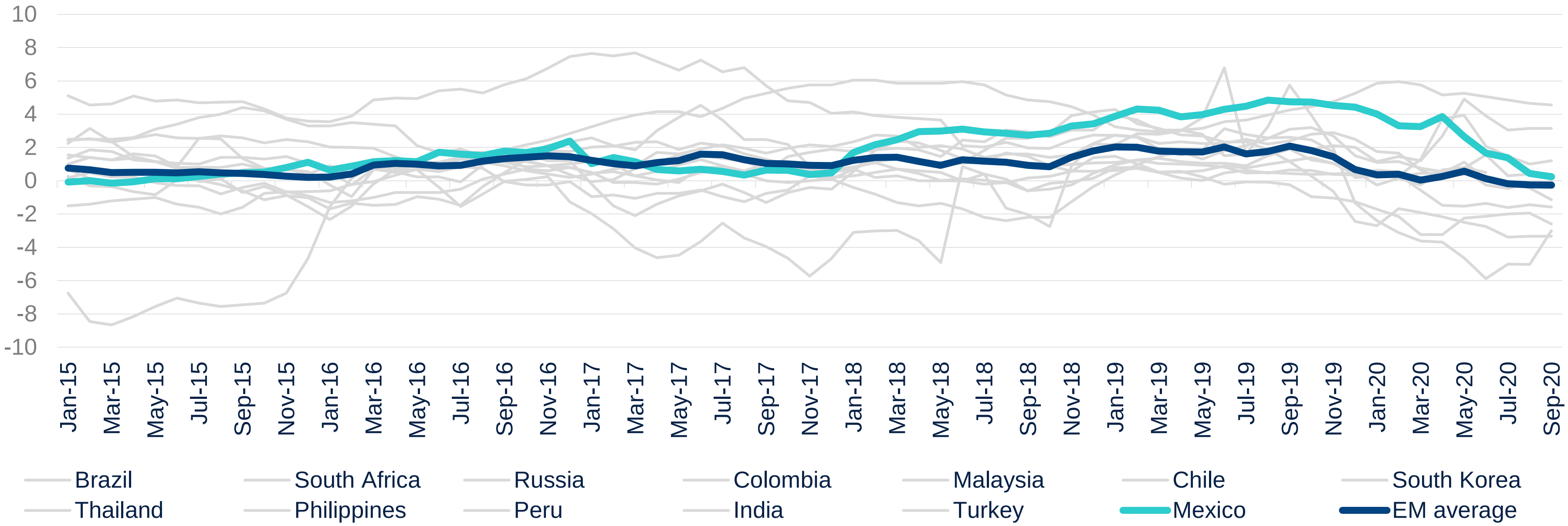


Source: BBVA Research/INEGI.

As inflation slows, the monetary rate would have to decrease in order to keep the real rate at around 0%

REAL EX-POST MONETARY POLICY RATES

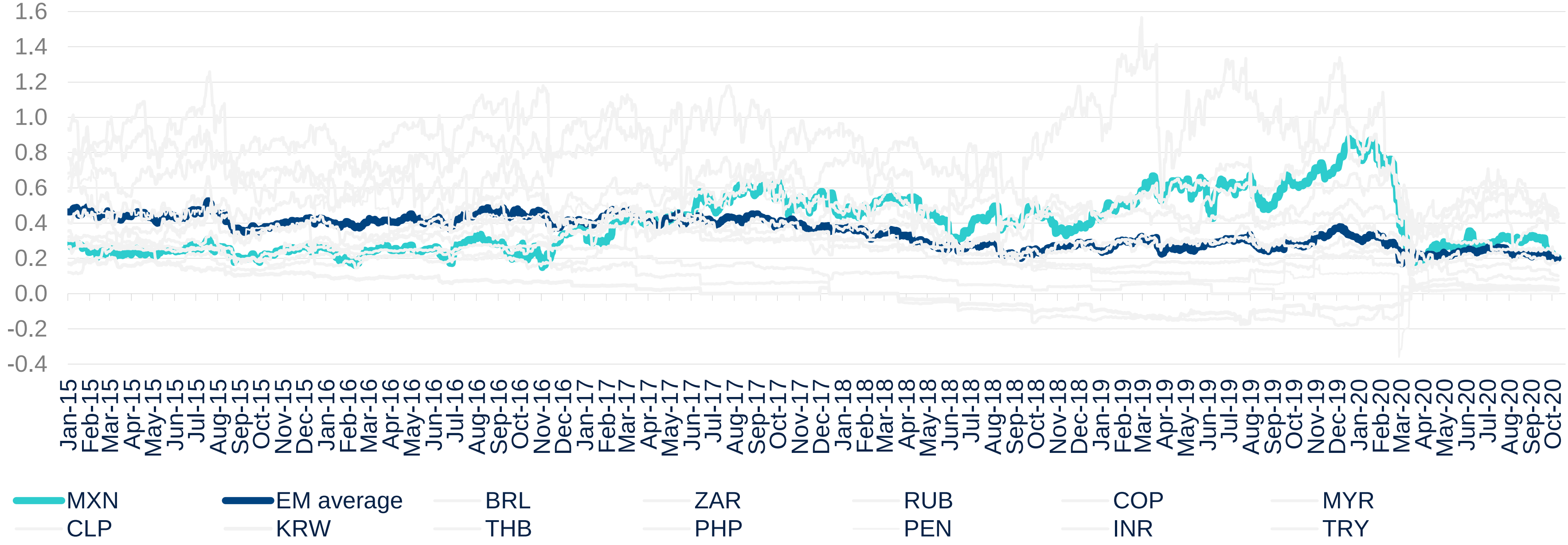
(%)



Source: BBVA Research/Bloomberg

The gradual increase in risk appetite will favor risk-adjusted carry-trade and could once again stand above the EM currency average

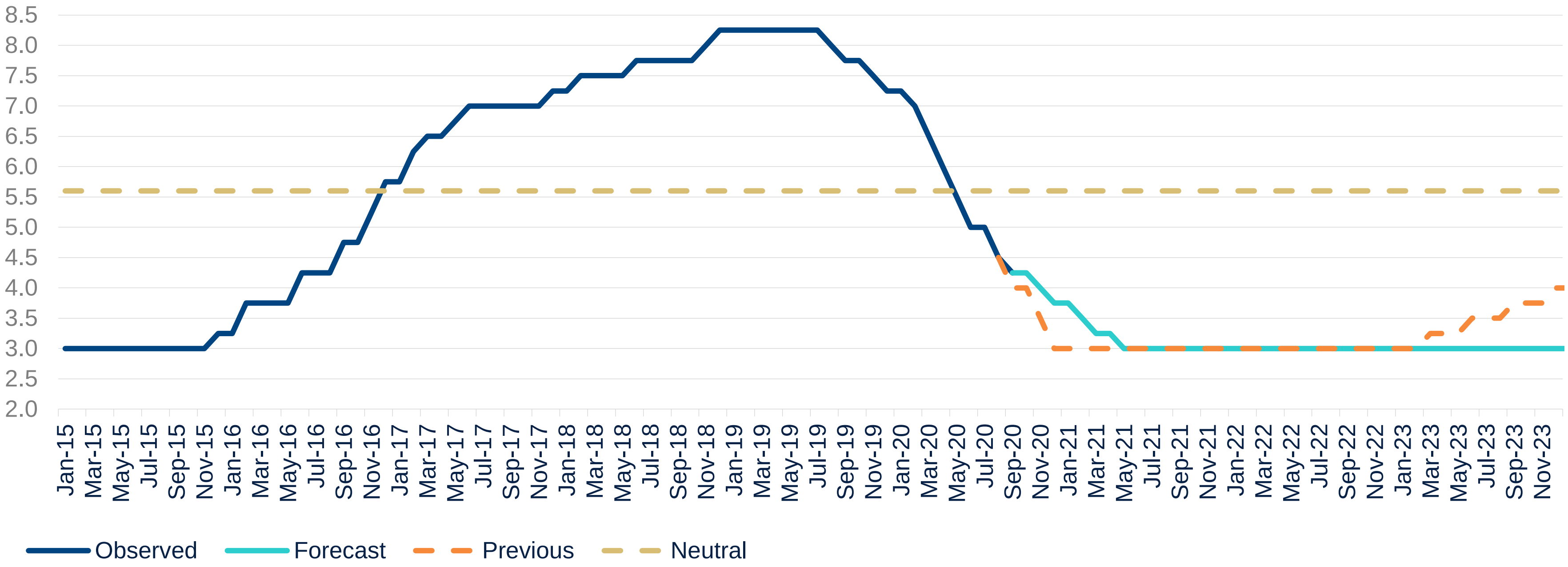
RISK-ADJUSTED CARRY TRADE
(%)



Source: BBVA Research/Bloomberg

We anticipate a slower decline, but expect lower rates to last for longer, with the Fed maintaining rates of 0% during 2021–23

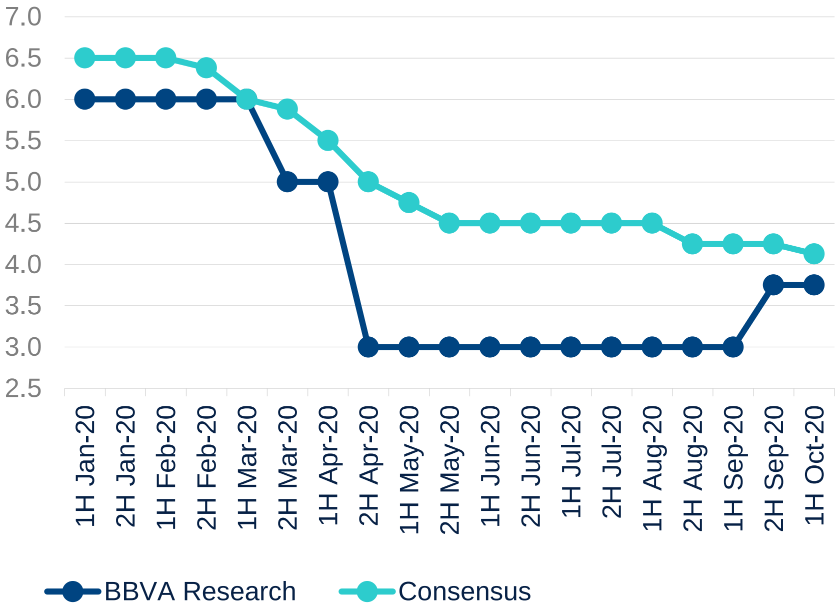
MONETARY RATE
(%)



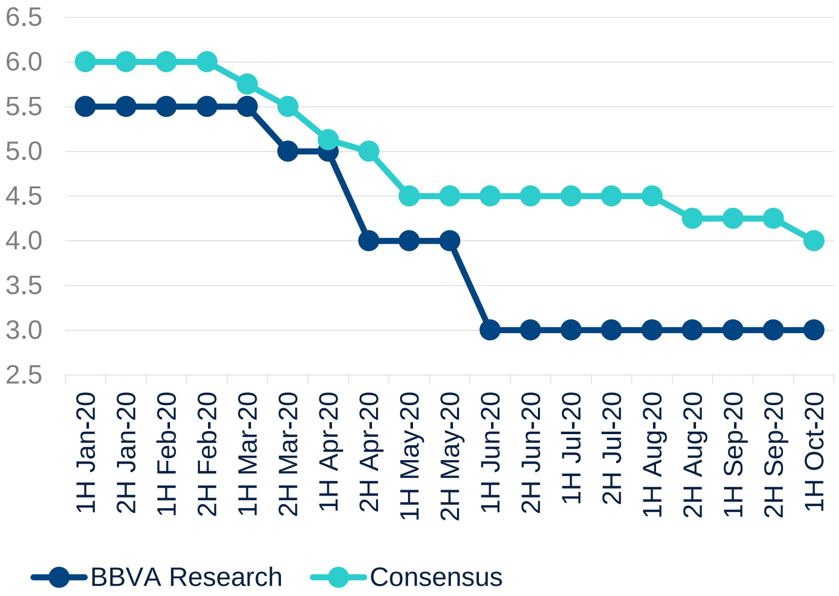
Source: BBVA Research/Banxico.

We expect Banxico to cut rateseven more than currently expected, as Banxico maintains rates close to 0% in real terms

ANALYSTS' EXPECTATIONS FOR THE MONETARY POLICY RATE IN 2020 (BBVA RESEARCH VS. CONSENSUS, EOP, %)



ANALYSTS' EXPECTATIONS FOR THE MONETARY RATE IN 2021 (BBVA RESEARCH VS. CONSENSUS, EOP, %)



Source: BBVA Research/CitiBanamex bi-weekly surveys.

Key points

The rebound in economic activity in 3Q20 has been higher than expected, although the pace will slow due to weak in domestic demand and a slowdown in external demand:

- We revised our growth forecast for 2020 upward to -9.3% (previously -10.0%) in view of the higher than expected rebound in 3Q20 (11.5% q/q compared to 10.2% previously) and the 0.2 pp upward revision of 2Q20 growth. Our growth forecast for 2021 remains at 3.7%, but we have extended our range from 2.0%-4.5% to 2.0%-5.0% due to increased uncertainty.
- Despite the supply-driven economic rebound in Q3, formal employment remains weak. We expect a slow recovery and that pre-pandemic employment levels will not be reached until 2024.

We continue to anticipate a slowdown in inflation and lower interest rates, however we now expect these lower levels to be delayed a few months:

- Inflation has showed signs of downward rigidity for longer than we anticipated; however, we still expect it to converge toward the 2021 target, after standing at 3.7% at the end of this year.
- The downward cycle will be slower than expected, but the accommodative stance will last longer with the Fed maintaining the official interest rate 0% during 2021–23.

There is still leeway for further appreciation of the peso; without significant risks to the balance of payments.

Public finances: public debt (% of GDP) will remain stable in 2021 provided that a tax reform is implemented.

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Summary of forecasts

Forecasts

		2019	2020	2021	2022	2023
GDP (Y/Y Change %)	new	-0.3	**-9.3**	**3.7**	**3.5**	**1.5**
	previous		-10	3.7	4.1	1.5
Employment (%, eop)	new	1.7	**-5**	**1.8**	**2.7**	**3.3**
	previous		-6.7	2.2	2.8	2.9
Inflation (%, eop)	new	2.8	**3.7**	**2.8**	**3**	**3**
	previous		3.4	2.8	3	3
Monetary rate (%, eop)	new	7.25	**3.75**	**3**	**3**	**3**
	previous		3	3	3	4
Exchange rate (ppd, eop)	new	19.1	**20.8**	**20.5**	**20.5**	**20.5**
	previous		21.4	20.5	20.5	20.5
M10 (%, eop)	new	6.89	**5.8**	**5.8**	**6.2**	**6.8**
	previous		5.5	6	6.4	6.9
Fiscal balance (% GDP)	new	-1.6	**-3**	**-3**	**-2.1**	**-2.1**
	previous		-3.6	-3.8	-2.1	-2.1
Checking account (% GDP)	new	-0.1	**-0.2**	**0**	**-2.2**	**-1.5**
	previous		-0.4	-0.2	-1.7	-1.4

Mexico Economic Outlook

4Q20

Creating Opportunities